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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

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**Form 10-Q**

- ☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**
- OR**
- ☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**
- 

For the Quarter Ended June 30, 2000

Commission File Number 0-25016

**T-NETIX, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

**Colorado**  
(State or Other Jurisdiction  
of Incorporation)

**84-1037352**  
(I.R.S. Employer  
Identification No.)

**67 Inverness Drive East**  
**Englewood, Colorado**  
(Address of principal executive offices)

**80112**  
(Zip Code)

Registrant's Telephone Number, Including Area Code: **(303) 790-9111**

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Indicate by check ☒ whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Class  
Common Stock, \$.01 stated value

Outstanding at August 10, 2000  
12,733,084

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## PART I

### Item 1. *Financial Statements*

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**T-NETIX, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited)

|  | June 30,<br>2000       | December 31,<br>1999 |
|--|------------------------|----------------------|
|  | (Amounts in Thousands) |                      |
| <b>ASSETS</b>  |                        |                      |
| Cash and cash equivalents.....   | \$ 298                 | \$ 118               |
| Accounts receivable, net .....   | 18,009                 | 16,459               |
| Prepaid expenses .....   | 1,569                  | 1,038                |
| Inventories .....  | 525                    | 710                  |
| Total current assets .....   | 20,401                 | 18,325               |
| Property and equipment, net .....  | 37,454                 | 33,858               |
| Goodwill, net .....  | 6,035                  | 6,401                |
| Deferred tax asset .....   | 2,243                  | 2,297                |
| Intangible and other assets, net.....  | 8,497                  | 9,252                |
| Total assets.....  | <u>\$ 74,630</u>       | <u>\$ 70,133</u>     |
| <b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK<br/>AND STOCKHOLDERS' EQUITY</b>  |                        |                      |
| <b>Liabilities:</b>  |                        |                      |
| Accounts payable.....  | \$ 15,810              | \$ 13,187            |
| Accrued liabilities .....  | 4,715                  | 5,924                |
| Current portion of long term debt .....  | 30,659                 | 7,366                |
| Total current liabilities .....  | 51,184                 | 26,477               |
| Long-term debt .....   | 77                     | 21,555               |
| Total liabilities .....  | 51,261                 | 48,032               |
| Series A redeemable convertible preferred stock, \$1,000 per share, stated value,<br>3,750 shares authorized; issued and outstanding at June 30, 2000; liquidation<br>preference of \$3,811,000 at June 30, 2000 ..... | 1,842                  | —                    |
| <b>Stockholders' equity:</b>   |                        |                      |
| Common stock, \$.01 stated value, 70,000,000 shares authorized; 12,733,084 and<br>12,699,400 shares issued and outstanding at June 30, 2000 and December 31,<br>1999, respectively .....                               | 127                    | 127                  |
| Additional paid-in capital .....   | 37,566                 | 35,791               |
| Accumulated deficit.....   | (16,166)               | (13,817)             |
| Total stockholders' equity .....   | <u>21,527</u>          | <u>22,101</u>        |
| <b>Commitments and contingencies</b>   |                        |                      |
| Total liabilities, redeemable convertible preferred<br>stock and stockholders' equity .....  | <u>\$ 74,630</u>       | <u>\$ 70,133</u>     |

See accompanying notes to condensed consolidated financial statements.

**T-NETIX, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)

|   | Three Months Ended<br>June 30,                      |                   | Six Months Ended<br>June 30, |                   |
|---|---|-------------------|------------------------------|-------------------|
|   | 2000  | 1999              | 2000                         | 1999              |
|   | (Amounts in Thousands, Except<br>Per Share Amounts) |                   |                              |                   |
| Revenue:  |   |                   |                              |                   |
| Telecommunications services .....   | \$11,953  | \$10,065          | \$22,077                     | \$19,879          |
| Direct call provisioning .....  | 7,247   | 7,021             | 14,492                       | 13,523            |
| Internet services .....   | 6,743   | —                 | 12,561                       | —                 |
| Equipment sales and other .....   | 826   | 660               | 1,208                        | 2,128             |
| Total revenue .....   | <u>26,769</u>                                       | <u>17,746</u>     | <u>50,338</u>                | <u>35,530</u>     |
| Expenses:   |   |                   |                              |                   |
| Operating costs:  |   |                   |                              |                   |
| Telecommunications services .....   | 5,360   | 4,263             | 9,861                        | 8,506             |
| Direct call provisioning .....  | 6,751   | 6,468             | 13,268                       | 12,548            |
| Internet services .....   | 5,550   | —                 | 10,648                       | —                 |
| Cost of equipment sold and other .....  | 332   | 214               | 549                          | 879               |
| Total operating costs .....   | 17,993  | 10,945            | 34,326                       | 21,933            |
| Selling, general and administrative .....                                     | 4,583   | 3,259             | 8,321                        | 6,619             |
| Research and development .....  | 1,569   | 1,253             | 2,744                        | 2,613             |
| Depreciation and amortization .....   | 3,117   | 2,848             | 6,166                        | 5,670             |
| Total expenses .....  | <u>27,262</u>                                       | <u>18,305</u>     | <u>51,557</u>                | <u>36,835</u>     |
| Operating loss .....  | (493)   | (559)             | (1,219)                      | (1,305)           |
| Merger transaction expenses .....   | —   | (827)             | —                            | (1,017)           |
| Interest and other expense, net .....   | (673)   | (633)             | (1,027)                      | (1,117)           |
| Loss before income taxes .....  | (1,166)   | (2,019)           | (2,246)                      | (3,439)           |
| Income tax benefit (expense) .....  | (103)   | 810               | (103)                        | 1,398             |
| Net loss .....  | (1,269)   | (1,209)           | (2,349)                      | (2,041)           |
| Accretion of discount on redeemable convertible preferred stock ....          | (430)   | —                 | (430)                        | —                 |
| Net loss applicable to common stock .....                                     | <u>\$ (1,699)</u>                                   | <u>\$ (1,209)</u> | <u>\$ (2,779)</u>            | <u>\$ (2,041)</u> |
| Basic and diluted loss per common share .....                                 | <u>\$ (0.13)</u>                                    | <u>\$ (0.10)</u>  | <u>\$ (0.22)</u>             | <u>\$ (0.17)</u>  |
| Shares used in computing basic and diluted net loss per<br>common share ..... | <u>12,701</u>                                       | <u>12,372</u>     | <u>12,756</u>                | <u>12,318</u>     |

See accompanying notes to condensed consolidated financial statements.

**T-NETIX, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

|   | Six Months Ended<br>June 30, |                 |
|---|------------------------------|-----------------|
|   | 2000                         | 1999            |
|   | (Amounts in<br>Thousands)    |                 |
| Cash flows from operating activities:   |                              |                 |
| Net loss .....  | \$(2,349)                    | \$(2,041)       |
| Adjustments to reconcile net loss to net cash provided by operating activities: |                              |                 |
| Depreciation and amortization .....   | 6,166                        | 5,670           |
| Deferred income tax benefit .....   | 54                           | (1,398)         |
| Gain on sale of property and equipment .....                                    | (265)                        | —               |
| Accretion of discount on subordinated note payable .....                        | (17)                         | —               |
| Changes in operating assets and liabilities:                                    |                              |                 |
| Accounts receivable, net .....  | (1,550)                      | 1,905           |
| Prepaid expenses .....  | (531)                        | (199)           |
| Inventories .....   | 185                          | (1,015)         |
| Intangibles and other assets .....  | (24)                         | (294)           |
| Accounts payable .....  | 2,623                        | 3,235           |
| Accrued liabilities .....   | (1,209)                      | (521)           |
| Cash provided by operating activities .....                                     | <u>3,083</u>                 | <u>5,342</u>    |
| Cash used in investing activities:  |                              |                 |
| Purchase of property and equipment .....  | (8,537)                      | (6,295)         |
| Proceeds from disposal of property and equipment .....                          | 285                          | —               |
| Other investing activities .....  | —                            | (894)           |
| Cash used in investing activities .....   | <u>(8,252)</u>               | <u>(7,189)</u>  |
| Cash flows from financing activities:   |                              |                 |
| Net proceeds from (payments on) line of credit .....                            | (807)                        | 3,390           |
| Proceeds from debt .....  | 3,750                        | 1,716           |
| Payments of debt .....  | (1,128)                      | (2,271)         |
| Proceeds from issuance of redeemable convertible preferred stock, net .....     | 3,459                        | —               |
| Common stock issued for cash under option plans .....                           | 75                           | 256             |
| Cash provided by financing activities .....                                     | <u>5,349</u>                 | <u>3,091</u>    |
| Net increase in cash and cash equivalents .....                                 | 180                          | 1,244           |
| Cash and cash equivalents at beginning of period .....                          | 118                          | 678             |
| Cash and cash equivalents at end of period .....                                | <u>\$ 298</u>                | <u>\$ 1,922</u> |
| Cash paid for interest .....  | <u>\$ 617</u>                | <u>\$ 1,088</u> |
| Cash paid for income taxes .....  | <u>\$ 103</u>                | <u>\$ 113</u>   |

See accompanying notes to condensed consolidated financial statements.

**T-NETIX, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**(1) Summary of Significant Accounting Policies**

*Unaudited Financial Statements*

The accompanying unaudited consolidated financial statements reflect all adjustments which, in the opinion of management, are necessary to reflect a fair presentation of the financial position and results of operations of T-NETIX, Inc. and subsidiaries (the Company) for the interim periods presented. All adjustments, in the opinion of management, are of a normal and recurring nature. Some adjustments involve estimates, which may require revision in subsequent interim periods or at year-end. The financial statements have been presented in accordance with generally accepted accounting principles. Refer to notes to consolidated financial statements, which appear in the 1999 Annual Report on Form 10-K for the Company's accounting policies, which are pertinent to these statements.

*Basis of Presentation*

On June 14, 1999, the Company completed a merger with Gateway Technologies, Inc. ("Gateway"), a privately held provider of inmate calling services. As a result of the merger, Gateway became a wholly owned subsidiary of the Company. Prior to the merger, the Company changed its year-end from July 31 to December 31. Gateway's year-end was December 31.

The merger was accounted for as a pooling of interests. As a result, the Company's financial statements have been restated to combine Gateway's financial statements as if the merger had occurred at the beginning of the earliest period presented. Information concerning common stock and per share data has been restated on an equivalent share basis.

*Liquidity*

The Company incurred losses from continuing operations in the three and six months ended June 30, 2000 of \$1.3 million and \$2.3 million, respectively and had a working capital deficit of \$30.8 million at June 30, 2000. In July 2000, the Company and its lenders amended the Company's credit agreement to revise certain financial covenants and extended the maturity date until April 30, 2001, and as a result the debt with the bank has been classified as a current liability. The Company raised \$7.5 million of additional financing in April 2000. The financing consisted of preferred stock and subordinated debt. The net proceeds of approximately \$7.2 million were used to reduce the outstanding balance on the credit facility.

The Company is taking steps to increase cash flow from operations, including renegotiating contract pricing and cost control measures, in order to carry out the remainder of its fiscal 2000 business plan. However, there can be no assurance that the Company will be successful in increasing its cash flow from operations and the Company may require additional financing to fund operations. In the event additional financing is required, the Company may not be able to obtain financing on terms acceptable to the Company and it may have to curtail operations.

*Earnings (Loss) Per Common Share*

Earnings (loss) per common share is presented in accordance with the provisions of Statement of Financial Accounting Standards No. 128, Earnings Per Share (SFAS 128). Basic earnings per share excludes the impact of potentially dilutive securities and is computed by dividing income or loss available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. There is no difference between basic and diluted net loss per share since potentially dilutive securities from the conversion of redeemable convertible preferred stock and the exercises of options and warrants are anti-dilutive for all periods presented. The calculations of diluted net loss per common share for the three and six months ended June 30, 2000 and 1999, do not include 991,000 and 748,000 and

# T-NETIX, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### (1) Summary of Significant Accounting Policies — (Continued)

385,000 and 424,000, respectively, of potentially dilutive securities, including common stock options and warrants and redeemable convertible preferred stock.

#### *Recent Accounting Pronouncements*

In March 2000, the Financial Accounting Standards Board ("FASB") issued interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation — an interpretation of APB Opinion No. 25 ("FIN 44"). This interpretation provides guidance on the accounting for certain stock option transactions and subsequent amendments to stock option transactions. FIN 44 is effective July 1, 2000, but certain provisions cover specific events that occur after either December 15, 1998 or January 12, 2000. The Company does not expect that the application of FIN 44 will have a material effect on its financial position or results of operations.

In December 1999, the SEC released Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements", which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. Subsequently, the SEC released SAB 101A, which delayed the implementation date of SAB 101 for the Company until the quarter ended December 31, 2000. The Company does not expect the application of SAB 101 to have a material impact on its financial position or results of operations.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 137. SFAS 137 defers the effective date of SFAS 133 to all fiscal quarters of all fiscal years beginning after June 15, 2000. SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. SFAS 133 requires companies to recognize all derivatives as either assets or liabilities, with the instruments measured at fair value. The accounting for changes in fair value, gains or losses, depends on the intended use of the derivative and its resulting designation. The Company does not expect the adoption of SFAS 133 to have a material impact on its financial position or results of operations.

#### *Reclassification*

Certain amounts in the 1999 financial statements have been reclassified to conform to the 2000 presentation.

### (2) Balance Sheet Components

Accounts receivable consist of the following:

|   | June 30,<br>2000       | December 31,<br>1999 |
|---|------------------------|----------------------|
|   | (Amounts in Thousands) |                      |
| Accounts receivable, net:                   |                        |                      |
| Trade accounts receivable .....             | \$13,684               | \$11,797             |
| Direct call provisioning receivable .....   | 5,343                  | 7,268                |
| Customer reimbursable receivable .....      | 377                    | 752                  |
| Other receivables .....                     | 213                    | 231                  |
|   | <u>19,617</u>          | <u>20,048</u>        |
| Less: Allowance for doubtful accounts ..... | <u>(1,608)</u>         | <u>(3,589)</u>       |
|   | <u>\$18,009</u>        | <u>\$16,459</u>      |

# T-NETIX, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### (2) Balance Sheet Components — (Continued)

Bad debt expense was \$1.5 million and \$1.6 million for the three months ended June 30, 2000 and 1999, respectively, and \$2.8 million and \$2.9 million for the six months ended June 30, 2000 and 1999, respectively.

Property and equipment consists of the following:

|   | June 30,<br>2000       | December 31,<br>1999 |
|---|------------------------|----------------------|
|   | (Amounts in Thousands) |                      |
| Property and equipment, net:                          |                        |                      |
| Telecommunications equipment .....                    | \$ 60,160              | \$ 55,487            |
| Construction in progress .....                        | 8,129                  | 7,341                |
| Office equipment .....                                | 10,696                 | 9,169                |
|   | 78,985                 | 71,997               |
| Less: Accumulated depreciation and amortization ..... | (41,531)               | (38,139)             |
|   | <u>\$ 37,454</u>       | <u>\$ 33,858</u>     |

Intangible and other assets consist of the following:

|  | June 30,<br>2000       | December 31,<br>1999 |
|--|------------------------|----------------------|
|  | (Amounts in Thousands) |                      |
| Intangible and other assets, net:            |                        |                      |
| Patent license rights .....                  | \$ 3,325               | \$ 3,325             |
| Purchased technology assets .....            | 2,487                  | 2,487                |
| Capitalized software development costs ..... | 663                    | 651                  |
| Acquired software technologies .....         | 1,791                  | 1,783                |
| Patent defense and application costs .....   | 2,579                  | 2,583                |
| Deposits and long-term prepayments .....     | 1,512                  | 1,183                |
| Other .....                                  | 1,386                  | 1,649                |
|  | 13,743                 | 13,661               |
| Less: Accumulated amortization .....         | (5,246)                | (4,409)              |
|  | <u>\$ 8,497</u>        | <u>\$ 9,252</u>      |

Accrued liabilities consist of the following:

|  | June 30,<br>2000       | December 31,<br>1999 |
|--|------------------------|----------------------|
|  | (Amounts in Thousands) |                      |
| Accrued liabilities:                         |                        |                      |
| Deferred revenue and customer advances ..... | \$1,667                | \$2,114              |
| Compensation related .....                   | 875                    | 1,175                |
| Other .....                                  | 2,173                  | 2,635                |
|  | <u>\$4,715</u>         | <u>\$5,924</u>       |

**T-NETIX, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(3) Debt**

Debt consists of the following:

|                                 | June 30,<br>2000       | December 31,<br>1999 |
|---------------------------------|------------------------|----------------------|
|                                 | (Amounts in Thousands) |                      |
| Debt:                           |                        |                      |
| Bank lines of credit .....      | \$26,704               | \$28,461             |
| Subordinated note payable ..... | 3,750                  | —                    |
| Other .....                     | 282                    | 460                  |
|                                 | 30,736                 | 28,921               |
| Less current portion .....      | 30,659                 | 7,366                |
| Non current portion .....       | <u>\$ 77</u>           | <u>\$21,555</u>      |

*Bank Line of Credit*

In September 1999, the Company entered into a Senior Secured Revolving Credit Facility (the "Credit Facility") with its commercial bank. The Credit Facility provides for maximum credit of \$40 million subject to limitations based on financial covenant calculations. The Credit Facility is comprised of a one year LIBOR component of \$15 million at an interest rate of LIBOR plus 4.0% at June 30, 2000; a one month LIBOR component of \$7 million at an interest rate of LIBOR plus 4.0% at June 30, 2000; and \$4.7 million at the Bank's prime rate, 9.5% at June 30, plus 1.25%. As of June 30, 2000, the total interest rates on borrowings under the bank Credit Facility ranged from 8.8% to 10.75%. The Company also pays a fee of 0.40% per annum on the unused portion of the line of credit.

The Credit Facility is collateralized by substantially all of the assets of the Company. Under the terms of the Credit Facility, the Company is required to maintain certain financial ratios and other financial covenants. These ratios include a debt to a four quarter rolling earnings before interest, taxes and depreciation and amortization (EBITDA) ratio, a ratio of fixed charges (interest and debt payments) to EBITDA, and minimum quarterly EBITDA. The agreement also prohibits the Company from incurring additional indebtedness.

In July 2000, the Company and its lenders amended its credit agreement to provide for revised financial covenants and extended the maturity date until April 30, 2001 and as a result the debt with the bank has been classified as a current liability. The Company raised \$7.5 million of additional financing in April 2000. The net proceeds were used to reduce the outstanding balance on the credit facility. As of June 30, 2000, the Company is in compliance with all terms of the agreement with the lenders. The maximum amount of credit under the credit facility available to the Company is dependent upon the Company's financial performance. Based on the financial covenants, the Company's maximum borrowings at June 30, 2000 are less than \$40 million.

*Subordinated Note Payable*

The Company issued a subordinated note payable of \$3.75 million, due April 30, 2001, to a director and significant shareholder of the Company. The note bears interest at prime rate plus one percent per annum (10.5% at June 30, 2000) which is payable every six months beginning in October 2000. The lender also received warrants to purchase 25,000 shares of common stock at an exercise price of \$6.05 per share for a period of five years. The estimated fair value of the stock purchase warrants, using the Black-Scholes model, has been recorded as deferred financing fees and is being amortized over the term of the debt.

## T-NETIX, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### (4) Stockholders Equity

##### *Preferred Stock Offering*

In April 2000, the Company issued 3,750 shares of our Series A Convertible Redeemable Preferred Stock and a five-year stock purchase warrant exercisable for 340,909 shares at \$6.60 per share of the Company's common stock to RGC International Investors, LLC, a fund managed by Rose Glen Capital Management LP. The Company allocated the fair value of the warrants (\$1.1 million) to additional paid-in capital and recognized a discount on the preferred shares issued. The net proceeds from the issuance were \$3.5 million, net of offering costs. The Company also issued warrants to purchase 50,000 shares of common stock to the broker on the sale of the preferred stock at an exercise price of \$6.60 per share. The stock purchase warrants were valued at fair value (\$163,000) using the Black-Scholes model and are being amortized as accretion of discount on preferred stock over the term of the preferred stock.

The preferred stock is convertible into common stock at a variable conversion price based on the closing market price of the common stock during a pricing period of 5 consecutive trading days during the 22 consecutive trading days preceding conversion, up to a "fixed" conversion price. The fixed conversion price is the lower of \$6.05 per share or 110% of the market price of the Company's common stock for 10 days ending on August 17, 2000 if it is below \$6.05. With limited exceptions relating to a change in control of the Company, during the six month period after the issuance of the preferred stock, the preferred stock is not convertible into the common stock unless the market price of the common stock equals or exceeds the fixed conversion price. After the six-month period, the Company has the right repurchase the preferred stock upon receipt of notice to convert the preferred shares into common stock, if the market price of the common stock is less than the fixed conversion price.

The preferred stock is redeemable at the option of the Company, subject to certain restrictions, if the market price of the Company's common stock is less than or equal to \$4.00 for 10 consecutive days. The redemption is subject to notice requirements. The cash redemption price is the greater of 120% of the liquidation preference, or a value based on the number of shares of common stock issuable upon conversion of the preferred stock multiplied by the highest closing price of the common stock during a period from notice of redemption until the redemption date. Redemption of the preferred stock is mandatory at its maturity date, April 17, 2003; upon assignment of all assets of the Company; bankruptcy; failure to maintain a Nasdaq listing; or failure to meet certain other terms set forth in the preferred stock agreements.

The preferred stock is non-voting and pays no dividends. In the event of liquidation, dissolution or winding up of the Company, or major transaction, including merger or sale or disposal of 50% of the company, the holders of the preferred stock are entitled to a liquidation preference of 8% per annum.

The Company accounted for these transactions in accordance with ETIF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios." The company recognized an increase in additional paid in capital in the amount of \$771,000 for the value of the beneficial conversion. The Company will accrete the resulting discount in the preferred stock to loss applicable to common stockholders over the six-month period beginning April 17, 2000.

#### (5) Segment Information

The Company has three reportable segments; the Corrections Divisions, the SpeakEZ Division, and the Internet Services Division. The Company evaluates performance based on earnings (loss) before income taxes. Additional measures include operating income, depreciation and amortization, and interest expense. There are no intersegment sales. The Company's reportable segments are specific business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. The accounting policies of the reportable segments are the same as those described in the summary of

# T-NETIX, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### (5) Segment Information — (Continued)

significant accounting policies. Segment information for the three and six months ended June 30, 2000 and 1999 is as follows (amounts in thousands):

|   | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|---|--------------------------------|-------------------|------------------------------|-------------------|
|   | 2000                           | 1999              | 2000                         | 1999              |
| <b>REVENUE FROM EXTERNAL CUSTOMERS:</b>             |                                |                   |                              |                   |
| Corrections Division .....                          | \$20,006                       | \$17,712          | \$37,677                     | \$35,471          |
| SpeakeEZ Division .....                             | 20                             | 34                | 100                          | 59                |
| Internet Services Division .....                    | 6,743                          | —                 | 12,561                       | —                 |
|   | <u>\$26,769</u>                | <u>\$17,746</u>   | <u>\$50,338</u>              | <u>\$35,530</u>   |
| <b>OPERATING INCOME (LOSS):</b>                     |                                |                   |                              |                   |
| Corrections Division .....                          | \$ (1,149)                     | \$ 15             | \$ (2,203)                   | \$ 64             |
| SpeakeEZ Division .....                             | (538)                          | (574)             | (928)                        | (1,369)           |
| Internet Services Division .....                    | 1,194                          | —                 | 1,912                        | —                 |
|   | <u>\$ (493)</u>                | <u>\$ (559)</u>   | <u>\$ (1,219)</u>            | <u>\$ (1,305)</u> |
| <b>DEPRECIATION AND AMORTIZATION:</b>               |                                |                   |                              |                   |
| Corrections Division .....                          | \$ 2,887                       | \$ 2,611          | \$ 5,699                     | \$ 5,173          |
| SpeakeEZ Division .....                             | 230                            | 237               | 467                          | 497               |
| Internet Services Division .....                    | —                              | —                 | —                            | —                 |
|   | <u>\$ 3,117</u>                | <u>\$ 2,848</u>   | <u>\$ 6,166</u>              | <u>\$ 5,670</u>   |
| <b>INTEREST AND OTHER EXPENSE, NET:</b>             |                                |                   |                              |                   |
| Corrections Division .....                          | \$ (367)                       | \$ (426)          | \$ (442)                     | \$ (703)          |
| SpeakeEZ Division .....                             | (306)                          | (207)             | (585)                        | (414)             |
| Internet Services Division .....                    | —                              | —                 | —                            | —                 |
|   | <u>\$ (673)</u>                | <u>\$ (633)</u>   | <u>\$ (1,027)</u>            | <u>\$ (1,117)</u> |
| <b>SEGMENT EARNINGS (LOSS) BEFORE INCOME TAXES:</b> |                                |                   |                              |                   |
| Corrections Division .....                          | \$ (1,516)                     | \$ (1,238)        | \$ (2,645)                   | \$ (1,656)        |
| SpeakeEZ Division .....                             | (844)                          | (781)             | (1,513)                      | (1,783)           |
| Internet Services Division .....                    | 1,194                          | —                 | 1,912                        | —                 |
|   | <u>\$ (1,166)</u>              | <u>\$ (2,019)</u> | <u>\$ (2,246)</u>            | <u>\$ (3,439)</u> |
| <b>SEGMENT ASSETS:</b>                              |                                |                   |                              |                   |
| Corrections Division .....                          |                                |                   | \$72,382                     | \$66,534          |
| SpeakeEZ Division .....                             |                                |                   | 2,248                        | 3,599             |
| Internet Services Division .....                    |                                |                   | —                            | —                 |
|   |                                |                   | <u>\$74,630</u>              | <u>\$70,133</u>   |

There was no intersegment revenue for the three months ended June 30, 2000 and 1999. Unallocated amounts to arrive at net earnings (loss) included an income tax (expense) benefit of \$(103,000) and \$1,398,000 for the six months ended June 30, 2000 and 1999, respectively. Consolidated total assets included eliminations of approximately \$12.7 million and \$13.0 million as of June 30, 2000 and December 31, 1999, respectively. Eliminations consist of intercompany receivables in the Corrections Division and intercompany payables in the SpeakeEZ Division related solely to intercompany borrowing of the SpeakeEZ Division.

## **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

For a comprehensive understanding of our financial condition and performance, this discussion should be considered in the context of the condensed consolidated financial statements and accompanying notes and other information contained herein.

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. Certain information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-Q includes forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements include, but are not limited to, those listed under the caption "Risk Factors" in the Company's Form 10-K for the year ended December 31, 1999, which may affect the potential technological obsolescence of existing systems, the renewal of existing site specific Corrections and Internet Service Division customer contracts, the ability to retain the base of current site specific customer contracts, the ability to perform under contractual performance requirements, the continued relationship with existing customers, the ability to win new contracts for our products and services, including Lock & Track™, Contain® and our Internet Services Division, the ability of our existing customers, including AT&T, to maintain their market share of the inmate calling market, the successful integration of Gateway Technologies, Inc. into our business, our ability to penetrate the market for jail management systems, the ability to reduce expenditures in the SpeakEZ Division and to successfully license voice verification and fraud prevention technology, the effect of economic conditions, the effect of regulation, including the Telecommunications Act of 1996 that could affect our sales or pricing, the impact of competitive products and pricing particularly in the our Corrections Division, our continuing ability to develop hardware and software products, commercialization and technological difficulties, manufacturing capacity and product supply constraints or difficulties, actual purchases by current and prospective customers under existing and expected agreements, and the results of financing efforts, along with the other risks detailed therein.

### **Overview**

#### *Acquisition of Gateway Technologies, Inc.*

On June 14, 1999, we completed our merger with Gateway Technologies, Inc. or "Gateway" by exchanging 3,672,234 shares of our common stock for all of the common stock of Gateway. Each share of Gateway was exchanged for 5.0375 shares of our common stock. In addition, outstanding Gateway stock options were converted at the same exchange rate into options to purchase approximately 379,000 shares of our common stock.

The merger constituted a tax-free reorganization and has been accounted for as a pooling of interests under Accounting Principles Board Opinion No. 16. Accordingly, all prior period information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations has been restated to include the combined results of operations, financial position and cash flows of T-NETIX and Gateway as though Gateway had always been a part of T-NETIX.

In addition, in connection with the merger transaction, T-NETIX issued 375,341 shares of common stock to certain shareholders of Gateway in exchange for their terminating a royalty agreement with Gateway. The royalty agreement related to automated call processing technology and intellectual property rights that were assigned to Gateway by the royalty owners in exchange for royalty payments. The termination of the royalty owners' interests resulted in the acquisition of an intangible asset. The asset has been recorded at its estimated fair value, or \$2,487,000. The fair value is based on the value of T-NETIX common stock at February 10, 1999 (date of the Merger Agreement), or \$6.625, multiplied by the number of shares issued in exchange for termination of the royalty owners' interests. The intangible asset has an estimated useful life of 10 years, the remaining term of the underlying patent.

#### *Corrections Division*

In the Corrections Division we derive revenue from three main sources: telecommunications services, direct call provisioning and equipment sales. Each form of revenue has specific and varying operating costs associated

with such revenue. Selling, general and administrative expenses, along with research and development and depreciation and amortization are common expenses regardless of the revenue generated.

Telecommunications services revenue is generated under long-term contracts. Pricing historically provided for transaction fees paid on a per-call basis. We are paid a prescribed fee for each call completed and additional fees for validating phone numbers dialed by inmates. The per-call charge is primarily for the provisioning of specialized call processing services to telecommunications service providers for their customers, the correctional facilities. However, recently we entered into a contract amendment with a significant customer to record revenue as a percentage of gross revenue earned by the customer, subject to certain adjustments. This new pricing was an effort by us to have our pricing remain flexible and not be effected by factors that affected call volumes. Pursuant to the amendment, we also recognized certain telecommunications expenses that were previously reimbursable charges to this customer. These charges were previously reimbursable costs to the customer. Our telecommunications service provider customers include AT&T, Bell Atlantic, Qwest (formerly US WEST), SBC Communications (including Ameritech), BellSouth, Sprint and GTE.

As a direct inmate call provider, we buy "wholesale" call services to be re-sold as collect calls. We use the services of third parties to bill the collect calls. We then enter into direct contracts with the correctional facilities and generally pay to the correctional facilities commissions on the gross billed revenue. The rates charged by us are consistent with the collect call rates charged by the incumbent local exchange carrier or "ILEC" in the same service area and the predominant interexchange carrier or "IXC". Since all calls originating from the inmate phones are collect calls, each phone generates higher-than-industry-average revenues. The uncertainty of the creditworthiness of the billed parties results however in a higher-than-industry-average uncollectible cost.

Equipment sales and other revenue includes the sales of our inmate calling system and the DRS system. The sales of the inmate calling system are generally made to only one customer. We then charge monthly maintenance fees to keep the system operational. Sales to this customer can vary depending upon the success of the customer in winning contracts with correctional facilities.

#### *Internet Services Division*

In December 1999, we entered into a master service agreement with US WEST INTERPRISE America, Inc. to provide interLATA Internet services to US WEST customers. The contract, which commenced December 1, 1999, calls for us to buy, resell and process billing of Internet bandwidth to this customer. The contract with US WEST is for a minimum of sixteen months.

We recognized significant Internet Services revenue and related costs for the three and six months ended June 30, 2000 under this agreement. Our gross margin on these services was 18% and 15% for the three and six months ended June 30, 2000, respectively. The gross margin is effected by the negotiated base management fee and contract incentive payments. The costs associated with this contract are primarily the costs for Internet bandwidth. There were no capital outlays required to begin provisioning these services. The Company anticipates adding personnel to expand the service offerings of the Internet Services Division beyond the scope of the current contract.

Extension of the contract beyond the minimum sixteen-month period is dependent upon the regulatory approval process in various states. In the event that US WEST receives regulatory approval to provide inter-LATA telecommunications services during or after the initial sixteen month period, our Internet Services revenue could be reduced significantly or eliminated.

#### *Speaker Verification Division*

We completed consolidation of our SpeakEZ operations to our Englewood facility in February 1999. The reorganization included a change in marketing strategy from a direct customer sales strategy to a technology licensing strategy. A direct customer sales strategy markets a specifically developed software product to a specific, end user customer. The strategy is then to find other specific customers who have similar operating systems and market this product to these customers. In contrast, a technology licensing strategy focuses on a larger scale customer who can integrate the SpeakEZ software product into its existing product line. This larger

customer, such as a computer manufacturer, would then be responsible for the product integration and ultimate delivery to the end user customer.

Even with the changes in marketing strategy, there can be no assurance that the products based on the SpeakEZ technology will achieve the necessary market acceptance or become widely adopted. The market for speaker verification software has only recently begun to develop. As is typical in the case of a new and rapidly evolving market, demand and market acceptance for recently introduced products and services are subject to a high level of uncertainty. Our voice print revenue has been minimal to date.

*Results of Operations for the Three Months Ended June 30, 2000 Compared to June 30, 1999*

The following table sets forth certain statement of operations data as a percentage of total revenue for the three months ended June 30, 2000 and 1999.

|   | <u>2000</u> | <u>1999</u> |
|---|-------------|-------------|
| Revenue:  |             |             |
| Telecommunications services .....                                     | 45%         | 57%         |
| Direct call provisioning .....  | 27          | 39          |
| Internet services .....   | 25          | —           |
| Equipment sales and other .....                                       | 3           | 4           |
| Total revenue .....   | 100         | 100         |
| Expenses:   |             |             |
| Operating costs .....   | 67          | 62          |
| Selling, general and administrative .....                             | 17          | 18          |
| Research and development .....  | 6           | 7           |
| Depreciation and amortization .....                                   | 12          | 16          |
| Operating loss .....  | (2)         | (3)         |
| Merger transaction expenses .....                                     | —           | (5)         |
| Interest and other expense .....                                      | (2)         | (3)         |
| Loss before income taxes .....  | (4)         | (11)        |
| Income tax (expense) benefit .....                                    | (1)         | 4           |
| Net loss .....  | (5)         | (7)         |
| Accretion of discount on redeemable convertible preferred stock ..... | (2)         | —           |
| Net loss applicable to common stock .....                             | <u>(7)%</u> | <u>(7)%</u> |

**Total Revenue.** Total revenue for the three months ended June 30, 2000 was \$26.8 million, an increase of 51% over \$17.8 million for the corresponding prior period. This increase was primarily attributable to the commencement of Internet services, as well as increases in telecommunications services revenue and equipment sales and other offset, in part by decreases in direct call provisioning revenue.

The 19% increase in telecommunications services revenue to \$12.0 million in the three months ended June 30, 2000, from \$10.1 million for the corresponding prior period, was due primarily to an increase in contract prices. We changed our pricing to a significant customer whereby revenue is calculated as a percentage of our customer's gross revenue versus a transaction fee per call. In addition we experienced an increase in revenue due to call volume increases, primarily due to the addition of new sites.

Direct call provisioning revenue increased to \$7.2 million for the three months ended June 30, 2000, from \$7.0 million in the corresponding prior period. This increase was due to the addition of sites for which we were provisioning the long distance service. The addition of sites is primarily a result of our being successful in competitive bidding arrangements for contracts directly with correctional institutions.

The Internet Services contract commenced in December 1999. Future revenue is dependent upon the base of subscribers and contract incentive payments. Internet gross margin for the three months ended June 30, 2000 was 18%.

Equipment sales and other revenue increased 25% to \$826,000 for the three months ended June 30, 2000 from \$660,000 in the corresponding prior period. Such sales are primarily associated with one telecommunications service provider customer and are dependent upon the timing of installations for this customer and the customer's success rate in its territory. In the three months ended June 30, 2000 we had sales of approximately \$676,000 to this telecommunications service provider customer. We do not expect significant equipment sales in the near future.

*Operating costs.* Total operating costs were \$18.0 million in the three months ended June 30, 2000, an increase of 64% from \$10.9 million in the corresponding prior period. The increases were primarily due to the commencement of Internet services as well as increases in telecommunication services and the cost of equipment sold and other expenses offset by a reduction in direct call provisioning expenses.

Operating costs of telecommunications services primarily consist of service administration costs for correctional facilities, including salaries and related personnel expenses, communication costs and inmate calling systems repair and maintenance expense. Operating costs of telecommunications services also include costs associated with call verification procedures, primarily network expenses and database access charges. Operating costs associated with direct call provisioning include the costs associated with telephone line access, long distance charges, commissions paid to correctional facilities, costs associated with uncollectible accounts and billing charges. Internet Services expense consists of Internet bandwidth costs. Cost of equipment sold and other includes primarily the purchase price of equipment which is resold. Other equipment cost components was minimal. Voice print operating costs include royalty charges, the cost of hardware and the cost of services which amounts are reflected as other operating costs.

The following table sets forth the operating costs and expenses for each type of revenue as a percentage of corresponding revenue for the three months ended June 30, 2000 and 1999.

|  | <u>2000</u> | <u>1999</u> |
|--|-------------|-------------|
| Operating costs:                       |             |             |
| Telecommunications services .....      | 45%         | 42%         |
| Direct call provisioning .....         | 93          | 92          |
| Internet services .....                | 82          | —           |
| Cost of equipment sold and other ..... | 40          | 32          |

Operating costs associated with providing telecommunications services as a percentage of corresponding revenue was 45% for the three months ended June 30, 2000, an increase from 42% for the corresponding prior period. The increase was due primarily to cost increases. Total telecommunications services operating expenses were \$5.4 million for the three months ended June 30, 2000 and \$4.3 million for the corresponding prior period. The increase in 2000 is due to new services being provisioned for a significant customer as part of a contract amendment and due to increases in personnel costs. The increase included bonus costs associated with our line installation bonus program. The bonus program ended as of June 30, 2000. Also, the addition of new personnel in the National Service Center and other operational support functions contributed to cost increases. To a lesser extent, increases in travel and contract labor contributed to the overall cost increase. With the addition or personnel at our National Service Center and based on contract negotiations we believe we can reduce field operations personnel in the near future.

Direct call provisioning costs as a percentage of applicable revenue increased slightly to 93% of revenue for the three months ended June 30, 2000 an increase from 92% for the corresponding prior period. These costs include increases due to site commissions and transmissions costs offset by a reduction in bad debt expense because of improved collections.

The contract for Internet services commenced in December 1999. Future revenue increases are dependent upon the base of subscribers and additional contract incentive payments. Cost of equipment sold and other increased in the three months ended June 30, 2000 and also increased as a percentage of corresponding revenue from the corresponding prior primarily due to the change in the revenue mix for equipment sales.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses were \$4.6 million for the three months ended June 30, 2000 compared to \$3.3 million for the corresponding prior period. Selling, general and administrative expenses associated with the Corrections Division were \$4.5 million for the three months ended June 30, 2000 compared to \$3.1 million in the corresponding prior period. The increase in the three months ended June 30, 2000 was primarily due to increases in salary and benefits for additional personnel, from raises for existing personnel and the installation bonus program. Other expenses, including travel and professional fees, increased due to the integration of Gateway's operations. We anticipate selling, general and administrative expenses to remain consistent with current levels in the near future.

*Research and Development Expenses.* Research and development expenses were \$1.6 million in the three months ended June 30, 2000 compared to \$1.3 million for the corresponding prior period. Research and development expenses for the Corrections Division were \$1.3 million in the three months ended June 30, 2000 and \$1.1 million in the corresponding prior period. The increase was primarily due to increased personnel expenses. We anticipate research and development expenses to remain consistent for the remainder of the year.

*Depreciation and Amortization Expenses.* Depreciation and amortization expense was \$3.1 million in the three months ended June 30, 2000, an increase from \$2.8 million for the corresponding prior period. The increase was due primarily to the depreciation associated with new site installations.

*Merger Transaction Expenses.* These expenses were directly related to the merger with Gateway and amounted to approximately \$827,000 for the three months ended June 30, 1999. Merger transaction expenses consisted primarily of fees for investment bankers, attorneys, accountants, financial printing and other related charges.

*Interest and Other Expense, Net.* Interest and other expense, net was \$673,000 for the three months ended June 30, 2000, an increase from \$633,000 for the corresponding prior period. Included in other income in the three months ended June 30, 2000 is a gain of approximately \$46,000 on the sale of used telecommunications equipment. Interest expense was \$719,000 for the three months ended June 30, 2000, and \$633,000 for the corresponding prior period. The increase in 2000 was attributable to an increase in the average amount of indebtedness outstanding and an increase in interest rates. The average debt balance increased primarily due to the increase in capital expenditures.

*Results of Operations for the Six Months Ended June 30, 2000 Compared to June 30, 1999*

The following table sets forth certain statement of operations data as a percentage of total revenue for the six months ended June 30, 2000 and 1999.

|   | <u>2000</u> | <u>1999</u> |
|---|-------------|-------------|
| Revenue:  |             |             |
| Telecommunications services .....                                     | 44%         | 56%         |
| Direct call provisioning .....  | 29          | 38          |
| Internet services .....   | 25          | —           |
| Equipment sales and other .....                                       | <u>2</u>    | <u>6</u>    |
| Total revenue .....   | 100         | 100         |
| Expenses:   |             |             |
| Operating costs .....   | 68          | 62          |
| Selling, general and administrative .....                             | 17          | 19          |
| Research and development .....  | 5           | 7           |
| Depreciation and amortization .....                                   | <u>12</u>   | <u>16</u>   |
| Operating loss .....  | (2)         | (4)         |
| Merger transaction expenses .....                                     | —           | (3)         |
| Interest and other expense .....                                      | <u>(2)</u>  | <u>(3)</u>  |
| Loss before income taxes .....  | (4)         | (10)        |
| Income tax (expense) benefit .....                                    | <u>—</u>    | <u>4</u>    |
| Net loss .....  | (4)         | (6)         |
| Accretion of discount on redeemable convertible preferred stock ..... | <u>(1)</u>  | <u>—</u>    |
| Net loss applicable to common stock .....                             | <u>(5)%</u> | <u>(6)%</u> |

**Total Revenue.** Total revenue for the six months ended June 30, 2000 was \$50.3 million, an increase of 42% over \$35.5 million for the corresponding prior period. This increase was primarily attributable to the commencement of Internet services, as well as increases in telecommunications services revenue and direct call provisioning revenue offset in part by decreases in equipment sales and other.

The 11% increase in telecommunications services revenue to \$22.1 million in the six months ended June 30, 2000, from \$19.9 million for the corresponding prior period, was due primarily to an increase in contract prices. We changed our pricing to a significant customer whereby revenue is calculated as a percentage of our customer's gross revenue versus a transaction fee per call. In addition we experienced an increase in revenue due to call volume increases, primarily due to the addition of new sites.

Direct call provisioning revenue increased 7% to \$14.5 million for the six months ended June 30, 2000, from \$13.5 million in the corresponding prior period. This increase was due to the addition of new sites primarily for which we are provisioning the long distance service. The addition of sites is primarily a result of our being successful in competitive bidding arrangements for contracts directly with correctional institutions.

The Internet Services contract commenced in December 1999. Future revenue increases are dependent upon the base of subscribers and additional contract incentive payments.

Equipment sales and other revenue decreased 43% to \$1.2 million for the six months ended June 30, 2000 from \$2.1 million in the corresponding prior period. Such sales are primarily associated with one telecommunications service provider customer and are dependent upon the timing of installations for this customer and the customer's success rate in its territory. In the six months ended June 30, 2000 we had sales of approximately \$1.1 million to this telecommunications service provider customer. The reduction for the six months ended June 30, 2000 from the corresponding prior period is due primarily to the timing of purchases by this customer.

**Operating costs.** Total operating costs were \$34.3 million in the six months ended June 30, 2000, an increase of 57% from \$21.9 million in the corresponding prior period. The increases were primarily due to the

commencement of Internet services as well as increases in telecommunication services and direct call provisioning expenses offset by a reduction in the cost of equipment sold and other expenses.

Operating costs of telecommunications services primarily consist of service administration costs for correctional facilities, including salaries and related personnel expenses, communication costs and inmate calling systems repair and maintenance expense. Operating costs of telecommunications services also include costs associated with call verification procedures, primarily network expenses and database access charges. Operating costs associated with direct call provisioning include the costs associated with telephone line access, long distance charges, commissions paid to correctional facilities, costs associated with uncollectible accounts and billing charges. Internet Services expense consists of Internet bandwidth costs. Cost of equipment sold and other includes primarily the purchase price of equipment which is resold. Other equipment cost components was minimal. Voice print operating costs include royalty charges, the cost of hardware and the cost of services which amounts are reflected as other operating costs.

The following table sets forth the operating costs and expenses for each type of revenue as a percentage of corresponding revenue for the six months ended June 30, 2000 and 1999.

|  | <u>2000</u> | <u>1999</u> |
|--|-------------|-------------|
| Operating costs:                       |             |             |
| Telecommunications services .....      | 45%         | 43%         |
| Direct call provisioning .....         | 92          | 93          |
| Internet services .....                | 85          | —           |
| Cost of equipment sold and other ..... | 45          | 41          |

Operating costs associated with providing telecommunications services as a percentage of corresponding revenue was 45% for the six months ended June 30, 2000, an increase from 43% for the corresponding prior period. The increase was due to cost increases. Total telecommunications services operating expenses were \$9.9 million for the six months ended June 30, 2000 and \$8.5 million for the corresponding prior period. The increase in 2000 is due to new services being provisioned for a significant customer as part of a contract amendment and due to increases in personnel costs. The increase included bonus costs associated with our line installation bonus program. The bonus program ended as of June 30, 2000. Also, the addition of new personnel in the National Service Center and other operational support functions contributed to cost increases. To a lesser extent, increases in travel, consulting services, repairs and maintenance contributed to the overall cost increase.

Direct call provisioning costs as a percentage of applicable revenue decreased to 92% of revenue for the six months ended June 30, 2000 from 93% in for the corresponding prior period. This decrease was primarily due to a reduction in bad debt expense because of improved collections.

The contract for Internet services commenced in December 1999. Cost of equipment sold and other decreased in the six months ended June 30, 2000 but increased as a percentage of corresponding revenue from the corresponding prior primarily due to the change in the revenue mix for equipment sales and voice print sales.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses were \$8.3 million for the six months ended June 30, 2000 compared to \$6.6 million for the corresponding prior period. Selling, general and administrative expenses associated with the Corrections Division were \$8.1 million for the six months ended June 30, 2000 compared to \$6.2 million in the corresponding prior period. The increase in the six months ended June 30, 2000 was primarily due to increases in salary and benefits for additional personnel, from raises for existing personnel and the installation bonus program. Other expenses increased due to travel, communications and professional fees due to the integration of Gateway operations.

*Research and Development Expenses.* Research and development expenses were \$2.7 million in the six months ended June 30, 2000 compared to \$2.6 million for the corresponding prior period. Research and development expenses for the Corrections Division were \$2.4 million in the six months ended June 30, 2000 and \$2.2 million in the corresponding prior period. The increase was primarily due to higher travel and consulting costs.

**Depreciation and Amortization Expenses.** Depreciation and amortization expense was \$6.2 million in the six months ended June 30, 2000, an increase from \$5.7 million for the corresponding prior period. The increase was due primarily to the depreciation associated with new site installations.

**Merger Transaction Expenses.** These expenses were directly related to the merger with Gateway and amounted to approximately \$1.0 million for the six months ended June 30, 1999. Merger transaction expenses consisted primarily of fees for investment bankers, attorneys, accountants, financial printing and other related charges.

**Interest and Other Expense, Net.** Interest and other expense, net was \$1.0 million for the six months ended June 30, 2000, a decrease from \$1.1 million for the corresponding prior period. Included in other income in the six months ended June 30, 2000 is a gain of approximately \$334,000 on the sale of used telecommunications equipment. There was \$59,000 of miscellaneous other income in the six months ended June 30, 1999. Interest expense was \$1.4 million for the six months ended June 30, 2000, and \$1.0 million for the corresponding prior period. The increase in 2000 was attributable to an increase in the average amount of indebtedness outstanding and an increase in interest rates. The average debt balance increased primarily due to the increase in capital expenditures and business acquisitions.

## Liquidity and Capital Resources

### Cash Flows

We incurred losses from continuing operations for the six months ended June 30, 2000 of \$2.3 million and had a working capital deficit of \$30.8 million at June 30, 2000. In July 2000 our lenders amended our credit agreement to provide for revised financial covenants. Additionally, we raised \$7.5 million of debt and equity financing in April 2000. The net proceeds were used to reduce the outstanding balance on our credit facility. We are taking steps to improve our cash flow from operations, including renegotiating contract pricing and cost control measures in order to carry out the remainder of our fiscal 2000 business plan. However, there can be no assurance that we will be successful in increasing our cash flow from operations and we may require additional financing to fund our operations. In the event additional financing is required, we may not be able to obtain financing on terms acceptable to us and we may have to curtail operations.

We present the following information for the six months ended June 30, 2000 and 1999 and as of June 30, 2000 and December 31, 1999:

|   | 2000                      | 1999      |
|---|---------------------------|-----------|
|   | (Amounts in<br>Thousands) |           |
| Cash provided by operating activities ..... | \$ 3,083                  | \$ 5,342  |
| Working capital deficit .....               | \$(30,783)                | \$(8,152) |

We have historically relied upon commercial borrowings, operating cash flow and the sale of equity securities to fund our operations and capital needs. Cash provided by operations decreased 42% to \$3.1 million for the six months ended June 30, 2000 from \$5.3 million in the corresponding prior period primarily due to an increase in the net loss, reductions in accounts payable, and increases in accounts receivable. The increase in the working capital deficit is primarily due to the classification of the bank credit facility. The current maturity of the facility is April 30, 2001.

Purchases of property and equipment were \$8.5 million in the six months ended June 30, 2000 compared to \$6.3 million for the corresponding prior period. The 36% increase in purchases of property and equipment was primarily due to additional inmate calling system installations and upgrades to existing systems.

### Debt and Equity

We have been funding our operations primarily from available borrowings under a line of credit and by using cash provided by operations. Due to our capital requirements for new installations and the merger with Gateway, in September 1999, we entered into a Senior Secured Revolving Credit Facility ("Credit Facility") with a

commercial bank. The maximum amount of credit under the credit facility available to the Company is dependent upon the Company's financial performance. Based on the financial covenants, the Company's maximum borrowings at June 30, 2000 were less than \$40 million. In July 2000 our lenders amended our credit agreement to revise certain financial covenants. In addition, we raised \$7.5 million of debt and equity financing in April 2000. The net proceeds of approximately \$7.2 million were used to reduce the outstanding balance on the Credit Facility.

We anticipate that our capital expenditures in 2000 will be consistent with 1999 based on our anticipated growth in installed systems at correctional facilities. We believe our Credit Facility and cash flows from operations will be sufficient in order for us to meet our anticipated cash needs for anticipated new installations of inmate call processing systems and upgrades of existing systems and to finance our operations for at least the next 12 months. However, there can be no assurance that we will be successful in increasing our cash flow from operations and we may require additional financing to fund operations. In the event additional financing is required, we may not be able to obtain financing on terms acceptable to us and we may have to curtail operations.

### ***Item 3. Quantitative and Qualitative Disclosure About Market Risk***

We are exposed to interest rate risk as discussed below.

#### **Interest Rate Risk**

We have current debt outstanding under the credit facility of \$26.7 million at June 30, 2000. The credit facility bears interest at differing rates including, \$22 million at LIBOR plus 4.0% and the remaining balance at the prime rate, 9.5% at June 30, 2000, plus 1.25%. Interest on LIBOR rate loans is payable at the end of the interest period applicable to the loan but not longer than every six months. Interest on prime rate loans is payable every six months. Since the interest rates on the loans outstanding are variable and are reset periodically, we are exposed to interest rate risk. An increase in interest rates of 1% would increase estimated annual interest expense by approximately \$280,000 based on the amount of borrowings outstanding under the line of credit at June 30, 2000.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

From time to time we have been, and expect to continue to be subject to various legal and administrative proceedings or various claims in the normal course of our business. We believe the ultimate disposition of these matters will not have a material affect on our financial condition, liquidity, or results of operations.

In a case brought in the First Judicial District Court of the State of New Mexico, styled *Valdez v. State of New Mexico, et. al.*, the complaint joins as defendants the State of New Mexico, several political subdivisions of the State of New Mexico and several inmate telecommunications service providers, including T-NETIX and Gateway. The complaint includes a request for certification by the court of a plaintiffs' class action consisting of all persons who have been billed for and paid for telephone calls initiated by an inmate confined in a jail, prison, detention center or other New Mexico correctional facility. The complaint alleges violations of New Mexico Unfair Practices Act, the New Mexico Antitrust Act and the New Mexico Constitution, and also alleges unjust enrichment, constructive trust, economic compulsion, constructive fraud and illegality of contracts, all in connection with the provision of "collect only" inmate telecommunications services. Although management believes the likelihood of an unfavorable outcome is low, there can be no assurance that a judgment against a class of defendant providers will not ultimately be entered.

In a case brought in the Superior Court of Washington for King County, styled *Sandy Judd, et al. v. American Telephone and Telegraph Company, et. al.*, the complaint joins as several inmate telecommunications service providers, including T-NETIX. The complaint includes a request for certification by the court of a plaintiffs' class action consisting of all persons who have been billed for and paid for telephone calls initiated by an inmate confined in a jail, prison, detention center or other Washington correctional facility. The complaint alleges violations of the Washington Consumer Protection Act and requests an injunction under the Washington Consumer Protection Act and common law to enjoin further violations. Although management believes the likelihood of an unfavorable outcome is low, there can be no assurance that a judgment against a class of defendant providers will not ultimately be entered.

Gateway is a defendant in a case brought in United States District Court Western District of Kentucky at Louisville, styled *Gus "Skip" Daleure, Jr., et al vs. Commonwealth of Kentucky, et al.* The complaint in this case joined as defendants several states, political subdivisions of states, and inmate service telecommunications providers and was filed contemporaneously with a request for certification by the court of a nationwide plaintiffs' class action consisting of all persons who have received and paid for telephone calls initiated by an inmate at a prison, jail or other correctional institution for the provision of "collect only" inmate telecommunications services. The complaint sought declaratory and injunctive relief and money damages in an unstated amount for alleged violations of the Sherman Antitrust Act, the Robinson-Patman Act and the U.S. Constitution. The district court held, on motions to dismiss; Kentucky did not have personal jurisdiction over defendants not located in or doing business in the state of Kentucky; that telephone calls are not goods or commodities and thus are not subject to the antitrust provisions of the Robinson-Patman Act; that Plaintiffs did not state a claim for relief under the Equal Protection Clause of the Fourteenth Amendment; and that Plaintiffs had not shown any harm in support of its antitrust claim under Section 1 of the Sherman Act. The trial judge did not, however, dismiss plaintiff's prayer for injunctive relief, despite these findings. The case is currently subject to appeal and cross appeal in the Second Circuit Court of Appeals. Although Gateway believes the District Court holding will not be overturned it is possible the in may be and there can be no assurance that a judgment against a class of the providers will not ultimately be entered.

### Item 2. Changes in Securities and Use of Proceeds

None

### Item 3. Defaults Upon Senior Securities

None.

**Item 4. *Submission of Matters to a Vote of Security Holders***

On May 12, 2000 the Company held its Annual Meeting of Shareholders to elect four directors of the Company to hold office until the 2003 Annual Meeting of Stockholders or until their respective successors are duly elected and qualified and to ratify the selection of KPMG LLP; independent auditors, as auditors of the Company for the year ending December 31, 2000. The directors were elected and KPMG was ratified as independent auditors with the following voting results; 10,712,465 FOR; 113,281 AGAINST; and 400 WITHHOLD.

**Item 5. *Other Information***

None.

**Item 6. *Exhibits and Reports on Form 8-K***

(a) Exhibits

- |       |   |
|-------|---|
| 10.12 | — First Amendment to Loan Agreement \$40,000,000 Revolving Line of Credit from Bank One, Colorado, NA, COBANK, ACB, and INTRUST Bank, NA dated July 11, 2000. |
| 27    | — Financial Data Schedule.  |

(b) The Company filed a Form 8-K dated April 19, 2000 reporting the following:

Item 5 on Form 8-K regarding additional equity financing.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

T-NETIX, INC.  
(Registrant)

By: /s/ ALVYN A. SCHOPP

Alvyn A. Schopp  
*Chief Executive Officer*

Date August 14, 2000